MULTIMEDIA UNIVERSITY

STUDENT IDENTIFICATION NO

MULTIMEDIA UNIVERSITY

FINAL EXAMINATION

TRIMESTER 2, 2018/ 2019

BAC4674 – INTEGRATED CASE STUDY
(All sections / groups)

15 MARCH 2019
9.00 a.m. – 12.00 p.m.
(3 Hours)

INSTRUCTIONS TO STUDENTS

1. This question paper consists of four pages with SIX (6) questions only.
2. Answer ALL questions. The marks distribution for each question is given at the end of each question
3. Please write all your answers in the answer booklet provided.

Grace and Elegance in the Fashion Industry

Grace and Elegance is chain retailer in the apparel and beauty industry. The industry is highly competitive where products are easily replaced and become dated. Proud as a trend-setter in the industry, Grace and Elegance targets its products toward the high-end segment of the market, offering luxurious shopping experience as well as value. Grace and Elegance stores could be found in many shopping establishments. Grace and Elegance has formed its brand image through advertising campaigns via the main mass media channels as well as specialised promotional events. Strategizing on marketing, design, price, service and quality, Grace and Elegance has established a brand name for itself.

The fashion retail industry is highly competitive. There is a broad range of other retailers including department stores, online sites, factory outlets, chain speciality stores, and individual retailers. The company's market share in the apparel-based retail industry has remained unchanged over the last three years. Although the company's profit margin is consistent with the industry's gross profit margin of 32%, the company must develop and maintain a competitive advantage in the industry in order to avoid adverse effect on future financial performance.

Grace and Elegance management has learned the hard way in 2013 and 2014 when they have over-invested in inventory of a well-known designer and the expected increase in sales did not materialise. In 2014, the company was required to write-off a significant portion of its inventory due to obsolescence. Following this setback, the company's board of directors has restructured the management team. Jason Weiss, a new CFO was appointed, together with a group of new management team. The new management team drives the company aggressively. Rules regarding merchandise consignment were changed and new rules were implemented. As a result, a number of their suppliers have terminated their contract with Grace and Elegance. To fulfil the void, the management has developed relationships with other suppliers who are mostly newcomers in the industry. The management also has commissioned designs from selected young designers.

In 2016, Grace and Elegance has extended its business hours in order to gain more sales. Although the move has indeed gained the expected sales, the company also experienced an increased in administrative costs due to overtime claims.

Business operations of Grace and Elegance are seasonal in nature, with two main selling seasons – December – February and June – August. The December – February period accounted for about one-third of net sales in 2016, 2017 and 2018. The seasonal nature of the business has caused seasonal fluctuations in net sales and operating income, with a significant operating income typically realised during December – February. The company closes its accounts on 31 March each year. This is to allow more time to count inventories and produce its annual financial statements following high selling period. The following financial information was extracted from the company's books.

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Grace and Elegance
Statement of Income for the year ended 31 March

	2018 RM'000	2017 RM'000	2016 RM'000
Net sales	244,455	217,325	195,945
Cost of goods sold	(167,960)	(149,555)	(135,285)
Gross profits	76,495	67,770	60,660
Operating expenses	(54,940)	(48,170)	(44,220)
Administrative expenses	(17,510)	(13,855)	(11,430)
Impairment of goodwill	(2,790)	0	(825)
Operating income	1,255	5,745	4,185
Interest expense	(4,175)	(4,055)	(4,025)
Other income	2,730	2,895	2,475
Income before income taxes	(190)	4,585	2,635
Provisions for Income Taxes	65	(1,555)	(905)
Net Income/(Loss)	(125)	3,030	1,730

Financial ratios	**2018**	**2017**
Current ratio	0.95	1.58
Acid test ratio	0.52	0.94
Debt to total assets	0.82	0.82
Collection period	28.85 days	30.14 days
Days to sell inventory	49.29 days	52.53 days
Total debt to equity	4.61	4.65
Long term debt to equity	1.81	2.98
Times interest earned	0.30	1.42
Gross profit margin	31.29%	31.18%
Operating profit margin	0.51%	2.64%
Pre-tax profit margin	-0.08%	2.11%
Net profit margin	-0.05%	1.39%
Cash turnover	15.63	10.67
Accounts receivable turnover	12.48	11.95
Inventory turnover	7.74	6.85
Operating cash flow ratio	0.004	0.011
Debt coverage ratio	0.01	0.02
Current liability coverage ratio	0.02	0.07
Long-term debt coverage ratio	0.03	0.04

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Other information:

- The impairment of goodwill in 2016 is related to the unsold inventories in 2014. In 2018, another goodwill impairment was charged due to the out-of-date merchandise. The impairment loss removes the entire goodwill balance related to the merchandise from the balance sheet. As on 31 March 2018, the company's balance sheet reported RM18,485,000 of goodwill.
- The statement of cash flows shows net inflows of cash provided by operations in each of the past three fiscal years.
- Currently the company has a debt agreement which contain covenants that require maintenance of certain financial ratios. Debt repayments is very much depended on cash flows from operations. Any decline in operating cash flow may cause the company inability to service the debt obligation.
- The company has two outstanding loans with local banks. The loans were used to finance most of its ongoing operations. One of the loans, amounting to RM3.1 million need to be settled in December 2018 and is secured by substantially all of the company's assets.
- The CFO is confident that the company will be able to secure a lender to buy out their current loan and avoid the payment due. According to the CFO, the management has a great relationship with their lenders, that the company was able to obtain a waiver on the current year's debt covenants that requires positive net income. Moreover, the company's sales and gross profit margins have steadily increased over the last three fiscal years – which signals the company's revival.

The management anticipates annual sales growth between 10 to 11 percent. In order to achieve this target, the company has developed the following strategies:

- The management believe that they have not fully explored the potential of online sales. This market segment could expand further with proper advertising and promotions. Thus, the management has allocated budget to promote their online store with special discounts and more widespread advertising. The management has started to revamp the online store to become more user-friendly and better facilitates online payments.
- The management plans to expand its business overseas. During a business trip in early 2018, a number of potential business partners has voiced their interest – one of which is Panaches Mode. Panaches Mode is a clothing company from Indonesia. The company proposed a co-branding strategy which enables Grace and Elegance to market its merchandise in Panaches Mode outlets in Indonesia and vice versa. The main term of Panaches Mode was that Grace and Elegance must only market its merchandise via Panaches Mode stores in the Indonesian market. The management has yet to make any decision regarding the offer as they have reservation related to Panaches Mode. Two years ago, Panaches Modes was alleged to have used child labour in their factories.

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- The management has engaged with a consultant to remodel Grace and Elegance stores. The remodelling exercise will involve renovation works and stores may need to be closed for a short period during the renovation.
- In order increase the company's market share, the management has decided to open new stores across the country. The new stores will adopt the new store concepts.

Required:

1. Identify three risk factors of the company that the audit team need to analyse during planning and throughout the audit. For each factor, indicate (i) the business risk and (ii) possible material misstatement in the financial statements.

   (18 marks)

2. Prepare a comparative income statement for Grace and Elegance. Fiscal year 2016 is to be used as the base year.

   (20 marks)

3. Analyse the comparative income statement prepared for requirement (2) above. What can you conclude on the company's performance?

   (10 marks)

4. What are the issues that may raise substantial doubt about the company's ability to continue as a going concern for the next 12 months? Please include specific financial information to support your response when applicable.

   (15 marks)

5. Evaluate the company's strategies to ensure sales growth. State the main considerations and risks of each strategy.

   (25 marks)

6. It is imperative that Grace and Elegance address its financial issues as soon as possible. Discuss:
   (i) A business strategy that Grace and Elegance could use in order to mitigate the current financial issues.
   (ii) Two (2) key considerations that Grace and Elegance need to address when implementing the recommended strategy.
   (iii) A risk factor that Grace and Elegance need to monitor whenever the strategy is implemented.

   (12 marks)
   (Total: 100 marks)

End of Paper